

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of }
SOUTH COAST COMPANY }

Appearances:

For Appellant: R. D. Sweeney, Attorney at Law

For Respondent: Burl D. Lack, Chief Counsel;
Crawford H. Thomas, Associate Tax Counsel

O P I N I O N

This appeal is made pursuant to Section 26077 of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying a claim of South Coast Company for refund of franchise tax in the amount of \$5,491.37 for the income year 1953.

Appellant is a California corporation engaged in the business of building ships. During the year in question Appellant reported income on the calendar year basis, used the accrual method of accounting and did business entirely within California.

Appellant entered into a contract with the United States Navy in 1951 for the construction of six minesweepers. The contract was one for a fixed price. The total price took into consideration labor and material prices existing at the time the contract was negotiated. Escalation clauses both as to labor costs and material costs were included in the contract. The labor escalation clause stated that the contract price was based upon a certain number of hours of direct labor at a straight-time, average hourly wage of \$1.89. The clause provided, among other provisions, that Appellant might request upward adjustment of the contract price if Appellant had to pay average hourly wages in excess of the stated average hourly wage of \$1.89 because of the terms of an agreement with a duly authorized bargaining agent representing Appellant's employees or because of a general increase in wage rates in the industry or in the locality. In the event Appellant should be entitled to request upward adjustment, the Appellant and the United States Navy were to agree on an adjustment which would equitably compensate Appellant for its increased cost of direct labor. This provision was limited by the restriction that Appellant was not to be allowed a greater net profit than \$342,054. Any adjustment was to be deferred until final settlement, but partial payments could be made on account of such increases as might accrue.

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Before construction began, the wage rates of direct labor were increased in Appellant's shipyard under the terms of an agreement with a duly authorized bargaining agent representing Appellant's employees and because of a general wage increase in the industry and in the locality. The average hourly wage rate for straight-time direct labor in 1953 and during the whole period of performance was \$2.1473.

Appellant reported gross income derived from the contract upon the percentage of completion method which required that it report as gross income in a particular year the percentage of the total contract price corresponding to the percentage of work completed during the year. In its return for 1953, in anticipation of the effect of the increased wage rates on the total contract price, Appellant reported a percentage of gross income which reflected the increased cost of wages.

By the terms of Appellant's contract the United States Government was to furnish Appellant with certain government owned property. The contract provided that in the event of delay in furnishing the government owned property an equitable adjustment would be made in the contract price. In 1955 Appellant submitted a claim under the labor escalation clause and a claim for damages resulting from delays in furnishing the government owned property. Some of the increased costs were due to delays in 1953. Appellant and the United States Navy negotiated concerning the amount of expense incurred by Appellant because of the delays and in 1956 agreed on an increase of \$211,000 in the total contract price as a settlement of any and all claims, including claims for escalation, arising out of the contract. The increase resulted in a profit of \$441,231.99, whereas the maximum profit that could have been allowed under the labor escalation clause was \$342,054.

Appellant included the \$211,000 settlement in 1956 income and asserted that it had improperly included the increased labor costs in accruing its income for 1953. It, therefore, filed a claim for refund of the taxes paid because of the inclusion of increased labor costs in its 1953 report of gross income. Respondent denied the claim for refund.

The issue to be decided is whether Appellant reflected excessive income by reporting as gross income in 1953 a percentage of the contract price as adjusted to reflect the increase in the straight-time average hourly wage.

If Appellant had elected to report on the ordinary accrual basis the applicable rule would be that income is accrued when the right to it is fixed and the amount is reasonably ascertainable. (Spring City Foundry Co. v. Commissioner, 292 U.S. 182; Continental Tie & Lumber Co. v. United States, 286 U.S. 290.)

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Appellant, however, elected to use the percentage of completion method of reporting its income. The rule of fixed right and certainty that applies with respect to the ordinary accrual method is relaxed when the taxpayer uses the percentage of completion method. (Alden Charles Palmer, 29 T.C. 154, aff'd 267 F. 2d 434, cert. denied 361 U.S. 821; Daley v. United States, 243 F.2d 466, cert. denied 355 U.S. 832.)

For example, it has been held that amounts to be withheld until completion of the contract are not reportable under the ordinary accrual method until the contract is completed (United States v. Harmon, 205 F.2d 919), but that such amounts are to be reported ratably as performance of the contract progresses in cases where the percentage of completion method is employed. (Rosa Orino, 34 B.T.A. 726; Berger Engineering Co., T.C. Memo., Dkt. No. 65321, Oct. 24, 1961.)

As stated in the Palmer case, supra:

And to say that as a matter of law there is and can be no accrual of long-term contract income so long as there are contingencies which, when resolved, might or could in some degree affect the amount of ultimate profits, would be to hold that the percentage of completion method of accounting for and reporting such income is unsound and without basis in the law. Such method of accounting for and reporting long-term contract income is based on the proposition that as a general rule such contracts move to completion substantially as anticipated and planned by the parties and that the work done in progress toward completion of the entire work reasonably and fairly reflects the earning of a ratable portion of the anticipated ultimate profit, and the accrual on an annual basis of the profits so indicated has long been accepted and established as a sound and proper method for recording and reporting long-term contract income. That is not to say, however, that a ratable accrual of the contract profits would still be required, if there were unresolved contingencies of such character as to render the ultimate collection thereof improbable and unlikely.

Appellant argues that the contract language in respect to recovery for increases in labor costs was permissive rather than mandatory. Appellant cites the provision to the effect that Appellant "might" request an upward adjustment. This language merely gave Appellant the option to request an adjustment. It certainly had no diminishing effect on Appellant's right to expect additional payment if the request were made.

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The contention is also advanced that the right could not have been fixed until completion of the contract and after further negotiations. This contention would be material only if Appellant had reported its income on the ordinary accrual basis. Appellant, however, elected to use the percentage of completion method. Under that method, the full amount of anticipated ultimate profit should be reported ratably as the performance of the contract progresses. (Alden Charles Palmer, supra; Berger Engineering Co., supra.)

At the inception of the contract here involved, the contract price was based upon an estimated number of working hours at a given hourly wage, with provision for an increase in the contract price if the hourly wage should increase. Before the performance of the contract began, the hourly wage increased and the original contract price was outmoded. When the cost of labor rose, Appellant could anticipate an upward adjustment which would "equitably compensate" for the increased cost.

If Appellant had reported the income for 1953 based upon the old contract price, its action would have been wholly at odds with the principle of the percentage of completion method. The new contract price could have been ascertained with reasonable accuracy by multiplying the new wage rate by the hours required for completion as set forth in the contract. The income could then have been reported based on the new contract price. This, in fact, appears to be what Appellant did originally, and we think that it was proper to do so.

Appellant contends that its ultimate recovery constituted damages for delays in the furnishing of government owned property and not for additional amounts under the labor escalation clause. This in no way affected the propriety of reporting a percentage of the additional amount that could have been anticipated in 1953. Appellant would have been entitled to an adjustment based on the escalation clause if the damage claim had not intervened and led to a greater profit than could have been obtained under the labor escalation clause itself. Some portion of that profit was earned in 1953 and, in our opinion, the amount originally reported by Appellant in its 1953 return was not an excessive amount.

A further argument by Appellant, that it might never have received the additional payments because they might have gone instead to a successor in interest, is untenable. Appellant presents no facts showing that such a contingency was at all likely at the end of 1953. In addition, in the Palmer case, supra, the court held that where a partnership was dissolved and a successor corporation took over its contract the partnership was liable for tax on income earned during the existence of the

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partnership even though the earnings were not actually paid over until after the contract was acquired by the corporation.

It is our conclusion that Appellant is not entitled to a refund.

O R D E R

Pursuant to the views expressed in the Opinion of the Board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to Section 26077 of the Revenue and Taxation Code that the action of the Franchise Tax Board in denying the claim of South Coast Company for refund of franchise tax in the amount of \$5,491.37 for the income year 1953 be and the same is hereby sustained.

Done at Sacramento, California, this 17th day of May, 1962, by the State Board of Equalization.

Geo. R. Reilly, Chairman

Richard Nevins, Member

Paul R. Leake, Member

John W. Lynch, Member

_____, Member

ATTEST: Dixwell L. Pierce, Secretary